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AMBO UNIVERSITY  
WOLISO CAMPUS  
SCHOOL OF GRADUATE STUDIES  
COLLEGE OF BUSINESS & ECONOMICS  
**INSTITUTIONAL ECONOMICS**  
LECTURE 1  
INTRODUCTION

1/24/2019

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# Lecture contents

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- i. The evolution of Institutional Economics
- ii. Core Assumptions of NIE
- iii. What are institutions?
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- How Institutional Economics Evolved?

# The evolution of Institutional Economics

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- Institutional economics evolved:
  - ✓ In quest for questions that neoclassical economics could not answer satisfactorily.
  - ✓ As the result of impractical assumptions of neoclassical economics.

# The evolution...

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- Assumptions of Neoclassical economics:
  - ✓ profit or utility maximization.
  - ✓ Perfect information.
  - ✓ Homogeneous, private products.
  - ✓ No barriers to entry or exit (costless).
  - ✓ Large numbers of buyers and sellers.
  - ✓ No economies of scale or production externalities
  - ✓ Complete set of markets.
  - ✓ Clear, enforced property rights.

# The evolution...

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- Questions not satisfactorily answered by Neoclassical economics:
  - ✓ Why do firms exist (in the variety of forms that they do)?
  - ✓ Why does vertical coordination within supply chains occur?
  - ✓ Why does sharecropping persist in rural areas of many low income economies?
  - ✓ Why does underdevelopment persist?
  - ✓ why does technological and economic convergence not occur?


# Core Assumptions of NIE

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1. Opportunism: “self-interest with guile”:
  - ✓ Shirking
  - ✓ Adverse selection
  - ✓ Moral hazard
  - ✓ Strategic default
  - ✓ Free-riding
2. Bounded rationality:
  - ✓ Reliance on conventions and norms

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- What are the institutions?



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- Institutions are: sets of rules, compliance procedures, moral and behavioral norms constraining the individual behaviors in the best interest of the society (North, 1981).
  - In more concrete form, institutions are:

# Institutions..

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- Rules of the game (North 1990).
  - ✓ Structure economic, political and social interaction
  - ✓ Predictability
- Incentives.
  - ✓ Rewards and punishments - “carrots” and “sticks”
  - ✓ Economic, legal, social
- Enforcement
  - ✓ law enforcement, social exclusion,
  - ✓ self-imposed codes of conduct

# Example: Ethiopian case

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- Contract farming arrangements for improved seed multiplications (Ethiopian seed enterprise (ESE) and smallholder farmers):
  - ✓ Inputs and pre-harvest services provided to the farmers.
  - ✓ Output prices pre-determined.
  - ✓ Agreement to sale outputs directly to ESE upon harvest.

# Example: Ethiopian case...

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- The challenges:
  - ✓ input diversion -shirking
  - ✓ Competing interest:
    - side-marketing,
    - strategic default
  - ✓ Setting of common price for all
    - No incentive

# Example: Ethiopian case...

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- Other issues:
  - ✓ Output price set too low (**no competition**).
    - Exacerbated side-marketing
  - ✓ Lack of penalty for input diversion or strategic default (**enforcement**)
  - ✓ ESE could not take the defaulters to court – **high transaction cost**,
  - ✓ Farmers self –selection into the scheme- **adverse selection**
  - ✓ lack of information sharing –**imperfect information**

# Classifications of Institutions

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- Can be classified based on different factors:
  1. Institutional environment
    - political, social, and legal ground rules that establish the basis for production, exchange and distribution
  2. institutional arrangements
    - modes of managing transactions (contracts etc)

# Classifications of Institutions...

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## 3. Formal:

- legal environment and property rights (written down and enforced by the state)

## 4. Informal

- norms and conventions (unwritten and informally sanctioned)
- Informal institutions change more slowly than formal .
  - ✓ What about Ethiopian constitution?

# Institutions and organizations

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- Institutions are rules of the game.
- Organizations are players of the game.
  - ✓ groups of individuals bound together by some common purpose to achieve certain objectives” (North 1993)
  - ✓ Examples: Universities, political parties, regulatory bodies, firms, family farms, cooperatives, churches, schools



# Institutions and organizations...

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- Institutions are within organizations
- Dynamic interaction between institutions and organizations:
  - ✓ Institutional environment influences which organizations exist.
  - ✓ Organizations create new institutional arrangements and lobby for changes in institutional environment.
  - ✓ Constant interplay between institutions and organizations.

# Institutions and organizations...

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- Institutional Economics Examines:
  - ✓ how the rules of the game affect economic growth and the structure of the economy.

# Institutions and organizations...

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- Institutions affect efficiency and productivity by influencing and coordinating:
  - ✓ consumption,
  - ✓ savings,
  - ✓ exchange,
  - ✓ investment,
  - ✓ Production, and
  - ✓ innovation.

# Elements of Institutional Economics

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- ✓ Property rights
- ✓ Transaction costs
- ✓ Path dependence: role of historical experience
- ✓ Law and Economics
- ✓ Regulation
- ✓ Governance
- ✓ Informal norms of behavior

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**THANK YOU**

1/24/2019

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